BEFORE THE

SURFACE TRANSPORTATION BOARD

EX PARTE NO. 664

METHODOLOGY TO BE EMPLOYED IN DETERMINING THE
RAILROAD INDUSTRY'S COST OF CAPITAL

REPLY COMMENTS OF
THE HONORABLE BRIAN SCHWEITZER, GOVERNOR, STATE OF MONTANA
ALLIANCE FOR RAIL COMPETITION
MONTANA WHEAT & BARLEY COMMITTEE
COLORADO WHEAT ADMINISTRATIVE COMMITTEE
COLORADO ASSOCIATION OF WHEAT GROWERS
IDAHO BARLEY COMMISSION
IDAHO WHEAT COMMISSION
IDAHO GRAIN PRODUCERS ASSOCIATION
MONTANA GRAIN GROWERS ASSOCIATION
NEBRASKA WHEAT BOARD
NEBRASKA WHEAT GROWERS ASSOCIATION
OKLAHOMA WHEAT COMMISSION
SOUTH DAKOTA WHEAT COMMISSION
SOUTH DAKOTA WHEAT INC.
TEXAS WHEAT PRODUCERS BOARD
TEXAS WHEAT PRODUCERS ASSOCIATION
WASHINGTON WHEAT COMMISSION
NATIONAL ASSOCIATION OF WHEAT GROWERS
NATIONAL BARLEY GROWERS ASSOCIATION

Terry C. Whiteside
Registered Practitioner
Whiteside & Associates
3203 Third Avenue North, #301
Billings, MT 59101
(404) 245-5132
twhiteside@wtp.net

John M. Cutler, Jr.
Andrew P. Goldstein
McCarthy, Sweeney & Harkaway, P.C.
2175 K Street, N.W., Suite 600
Washington, DC 20037
(202) 775-5560
jcutler@mshpc.com
apg@mshpc.com

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The Opening Comments filed September 27, 2007 by the Honorable Brian Schweitzer, Governor of Montana, and various Agricultural Interests predicted that the Railroads would see the Board's proposal in this proceeding as a threat to a regulatory status quo that is highly favorable to their industry. That prediction has been confirmed by the Opening Comments filed by the AAR and separate Comments of the Class I Railroads.

What is surprising about the Railroads' Comments is how little substance there is to their criticisms of the Capital Asset Pricing Model ("CAPM") as a substitute for the Discounted Cash Flow ("DCF") approach to assessing the railroad industry's cost of capital. As AAR Witness Glenn Hubbard candidly acknowledges, "Neither model is inherently superior to the other, and ideally, both models should yield comparable results." Verified Statement at 3-4. See also the Verified Statement of AAR Witness Myers at 7: "I am not recommending that the Board reject the CAPM model and return to the sole reliance on the constant-growth DCF formula."

Thus, while the Railroads argue for a higher cost of capital, these arguments do <u>not</u> rest on a fundamental rejection of CAPM as an approach. The Board should adopt CAPM as proposed in its August 14, 2007 Notice of Proposed Rulemaking.

To some extent, the Railroads call for a higher cost of capital on technical accounting grounds. As to those arguments, Governor Schweitzer and these Agricultural Interests generally support the Reply Comments being filed by Western Coal Traffic League. To a larger extent, however, the Railroads argue for a higher cost of capital based not on financial realities but due to the perceived regulatory advantages of continuing to be designated revenue inadequate. These arguments are specious, for multiple reasons.

A particularly glaring defect in the Railroads' analysis is their failure to acknowledge the limited scope of the STB's rate reasonableness jurisdiction. See, e.g., the Verified Statement of AAR Witness Myers at 3: "I understand that railroads deemed revenue-adequate could face limits on what they can charge for transportation."

Witness Myers is a Professor of Economics and may have been misinformed, but Railroad witnesses who know better make similar claims. See the Verified Statement of UP Chief Financial Officer Knight at 8: "When the Board calculates the cost of capital, it effectively tells the company, our shareholders and financial markets the maximum level of returns that we will be allowed to achieve over time." <u>This statement is simply false</u>. Reflecting the same error is BNSF Chief Financial Officer Hund's warning (V.S. at 4-5): "If, however, the Board effectively caps BNSF's earning capacity at a level that does not reflect the real-world cost of capital, BNSF will be unable to justify continuing investment or, indeed, to attract the capital necessary for such investment."

The STB has jurisdiction over rail rates <u>only</u> where market dominance is found, under 49 U.S.C. § 10707, and <u>only</u> the rates on captive traffic are required by law to be reasonable. 49 U.S.C. § 10701(d)(1). These restrictions exclude all freight moving at rates below the jurisdictional threshold, or where there is an absence of qualitative market dominance (i.e., where effective intermodal or intramodal competition exists), or where the freight is exempt.

In recent testimony on Capitol Hill, Board Chairman Nottingham estimated that "less than 10% of the nation's freight rail traffic is recognized as captive and eligible for

STB rate regulation." Testimony before House Committee on Transportation and Infrastructure Hearing on Rail Competition and Service, September 25, 2007, at page 1. The vast majority of rail freight in America is therefore not even potentially subject to a "cap" on railroad rates, and the Railroad witnesses' claims to the contrary are specious.

The Class I railroads have been able to obtain financing on Wall Street for years despite consistent ICC and STB findings that they were revenue inadequate. Formal findings that they are revenue adequate should be good news for investors, just as reports of increased revenues are good news for investors in other industries.

Indeed, the Railroads' future has never been brighter. As BNSF Witness Hund points out, "the demand for rail transportation, measured in tonnage, will increase by 88% by 2035," V.S. at 3. Capacity constraints facing other modes make it highly likely that railroads will be in a position not to lose market share to motor, water or air carriers. Even without improved service, Railroads may gain market share, and such gains are more likely if service improves. Inadequate investment in highway infrastructure, tolling of existing roads, congestion, driver shortages and environmental issues make any fears of massive diversion of freight from trains to trucks unrealistic, absent major (and highly unlikely) changes in current government policies.

The Railroads are also fond of arguing that their recent rate increases simply reflect fundamental laws of supply and demand. If this is the case, the Railroads can expect dramatic revenue gains from the 90% of their existing customers (as well as new non-captive customers), whom the Railroads can legally charge anything they like.

The Railroads "cap" arguments do not make sense even in the context of the 10% of rail freight that is estimated to be subject to STB rate jurisdiction. As detailed in the

Opening Comments filed in this proceeding by Governor Schweitzer and these Agricultural Interests, effective regulation of rail rates has been nonexistent for decades.

While it is true that large coal shippers were able to obtain some relief under the Stand-Alone Cost test in a handful of rate cases in the 1980s and 1990s, recent SAC decisions have consistently gone against shipper complainants. In any event, SAC cases are prohibitively expensive for shippers other than large-volume point to point shippers like electric utilities, and recent changes in STB SAC procedures appear to make relief even less likely in the future for large captive coal shippers.

The obstacles to relief for smaller and non-coal shippers are even more formidable. In the first place, many are too fearful of railroad retaliation, and too skeptical about Board fairness, to try to pursue relief from high rail rates. If the shipper were to prevail, a market dominant railroad could jeopardize or terminate the successful complainant's business through poor service or in other ways.[1]

Smaller shippers unable to use SAC must also prove that they are captive, and are then faced with a Simplified SAC approach recently adopted by the Board that will not work for many, if any, such shippers. Relief for shippers not located on and shipping exclusively via high density main lines will be foreclosed by the Board's segment cross-subsidy test.

Shippers able to surmount that obstacle face a version of SAC that is neither simple, because they must analyze <u>all</u> traffic on any hypothetical competing line, nor fair, because all potential efficiency improvements are assumed away in the interest of reduc-

[1] During the Hearing held October 23, 2007 before a subcommittee of the Senate Commerce Committee, a witness representing producers of agricultural commodities commented on the difficulty of obtaining testimony from grain elevator operators because the STB does not have a "witness protection program."

ing litigation cost. This amounts to making sure Simplified SAC cases will be inexpensive by making sure they will be unsuccessful.

Only the Three Benchmark test appears to offer hope of regulatory recourse that may actually lead to rate relief, and there are many open questions about the effectiveness of the Three Benchmark approach. At best, it appears that relief will be limited to $1,000,000 in rate reductions spread out over a five-year period, or $200,000 per year, no matter how much the challenged rates may exceed maximum reasonable levels.[2]

It is true that, if the Railroads attain "long-term" revenue adequacy, it may be possible for captive shippers to invoke the "revenue adequacy constraint" adopted in 1985 as part of Constrained Market Pricing, and unused in any rail rate case since then.[3] However, assuming that constraint does become available to captive shippers not vulnerable to Railroad intimidation and retaliation, it is not clear how effective it will be.

Nothing in Coal Rate Guidelines suggests that past rate increases on captive shippers will be subject to reductions based on the attainment of long-term revenue adequacy. And while it does appear that railroads seeking further increases in rates set through differential pricing may face additional burdens in justifying such increases, there is nothing unfair in this result. Once railroads are able to attract needed capital without further differential pricing, it is entirely appropriate for them to look more to rate increases on the 90% of their customers who are not captive, and to investment capital from the financial markets, for revenue growth.

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[2] Governor Schweitzer and these Agricultural Interests have joined with other shippers in seeking reconsideration of the Board's decision in Ex Parte No. 646 (Sub-No. 1), Simplified Standards for Rail Rate Cases, in hopes of making the Three Benchmark test more effective as a remedy for excessive rail rates. They have also intervened in the Railroads' court appeals of that decision to defend the Three Benchmark approach against the Railroads' efforts to eliminate the only approach that appears likely to help smaller captive shippers.

[3] Coal Rate Guidelines, Nationwide, 1 I.C.C. 2d 520, 535-36 (1985), aff'd. Consolidated Rail Corp. v. United States, 812 F. 2d 1444 (3d Cir. 1987).

For over 20 years, market dominant railroads have enjoyed extraordinary freedom to impose whatever rates and rate increases they chose on captive shippers including these Agricultural Interests and other Montana shippers. The statutory guarantee of reasonable rates for captive shippers unable to afford SAC cases was an empty promise, and the nation's captive shippers have contributed more than their share to the restoration of Railroad industry financial strength. If the Railroads have not always enjoyed the revenue levels they wanted, regulation was not to blame.

After more than 20 years of defenselessness in the face of Railroad abuses of market power, captive shippers deserve relief. This does <u>not</u> mean underinvestment in rail infrastructure. It simply means that Railroads seeking new capital will need to exercise their pricing freedom over the 90% of their customers not designated by Congress as entitled to regulatory protection against excessive rail rates. Railroads may need to rely less on differential pricing of captive traffic, but no law prevents them from maximizing revenue, including through differential or "value of service" pricing, from the vast majority of their customers. There can be no doubt as to the ability of those customers to pay more for increasingly scarce rail capacity, and there can be no doubt as to the attractiveness to investors of such a business model. What is harder to understand is why the Railroads would resist formal confirmation of their ability to earn the revenues they need without monopoly rate gouging.

The bottom line is that Railroad claims of disaster if the Board adopts CAPM, and if the Board then goes on to find the major Class I Railroads revenue adequate, are simply not credible. The Railroads' CFOs and their outside counsel know that regulated traffic represents a small minority of their freight, and also know that capacity constraints give them new pricing power over the vast majority of their traffic.

Why then the unbroken message of alarmism in the Railroads' comments in this proceeding? Assuming the Railroads know better than to expect the Board to be unaware of its limited rate jurisdiction, only one explanation appears to make sense. The Railroads' comments are presumably part of an extensive public relations campaign aimed at attracting political support from Wall Street analysts, and possibly busy Members of Congress who do not understand the reality that 90% of rail freight is now and will remain almost completely unregulated, even if pending captive shipper legislation is enacted by Congress.[4]

Governor Schweitzer and these Agricultural Interests understand the Railroads' incentive to preserve their current advantages. No other industry in the U.S. enjoys the Railroads' combination of freedom from competition (at least as to captive traffic) and freedom from effective regulation. However, maintaining these aspects of the status quo is an illegitimate goal even as a matter of public policy. Assuming there were policy grounds in the 1980s for regulatory decisions giving the benefit of virtually every doubt to the Railroads, there are none today. The Railroads do not need or deserve an unrestricted right, in perpetuity, to raise rates on captive traffic in order to attract capital and make infrastructure investments.

In any event, the subject of this proceeding is not public policy, no matter how hard the Railroads may try to shift the focus to threats concerning infrastructure investment and arguments for replacement cost accounting. It is rather how best to assess the

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[4] Because of their doubts about the effectiveness of regulatory recourse under current law, Governor Schweitzer and these Agricultural Interests are strong supporters of H.R. 2125 and S. 953, the Railroad Competition and Service Improvement Act of 2007.

Railroads' cost of capital. It is neither reasonable nor proper for the Railroads to ask the Board to adhere to a <u>less</u> accurate method of making that assessment, merely because DCF better serves the Railroads' desire for differential pricing of captive traffic when such pricing can no longer be justified.

For the foregoing reasons, and for the reasons set forth in their Opening Comments and in the Comments filed in this proceeding by Western Coal Traffic League and the U.S. Department of Agriculture, Governor Schweitzer and these Agricultural Interests urge the Board to replace DCF with CAPM as proposed in its August 14 Notice, and to proceed thereafter to find the majority of Class I Railroads revenue adequate.

Respectfully submitted,

Terry C. Whiteside
Registered Practitioner
Whiteside & Associates
3203 Third Avenue North, #301
Billings, MT 59101
(404) 245-5132
twhiteside@wtp.net

John M. Cutler, Jr.
Andrew P. Goldstein
McCarthy, Sweeney & Harkaway, P.C.
2175 K Street, N.W., Suite 600
Washington, DC 20037
(202) 775-5560
jcutler@mshpc.com
apg@mshpc.com

CERTIFICATE OF SERVICE

I hereby certify that I have, this 29th day of October, 2007 served a copy of the foregoing on all parties of record, by first class mail, postage prepaid.

John M. Cutler, Jr.

s:\Montana\Reply Comment